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THE FISCAL DILEMMA FACING LOCAL GOVERNMENT

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THE FISCAL DILEMMA FACING LOCAL GOVERNMENT

MONDAY, JANUARY 23, 1984

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in the U.S. Court of International Trade, 1 Federal Plaza, New York, N.Y., Hon. Alfonse M. D'Amato (member of the committee) presiding.

Present: Senator D'Amato.

Also present: Robert Salomon, legislative assistant to Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO, PRESIDING

Senator D'AMATO. Good morning. I now convene the Joint Economic Committee for today's hearing on the Fiscal Dilemma Facing Local Government.

To the best of my knowledge, this is the first hearing of the 98th Congress to examine existing avenues of municipal finance and local governments' ability to fund ongoing operations and capital projects. The Federal Government sets policy affecting the financial decisions of businesses, individual citizens, and State and local government. Of course, since each of these groups conducts lobbying campaigns attempting to influence Federal decisionmaking in favor of their particular interests, business interests, as well as private citizen groups, are very effective in molding Federal policy.

But who represents the existing avenues of State and local finance? The workings of the municipal bond market is a very esoteric and complicated subject, few interest groups and, thus, few voters, understand the public financial markets. Consequently, the breadth of the municipal bond market has been gradually and seriously diminished over the past 10 years.

As a former local official, I well understand the importance of the public securities markets. Put simply, it boils down to jobs and safety. If the Nation's cities and towns cannot raise sufficient external funds, major projects and general services will be cut. This will hurt primarily the poor and the middle class who rely on local services. As general services are cut, our cities become increasingly unlivable. Ultimately, individuals, and businesses leave the region.

Allow me to discuss another problem facing local government. This committee is in the process of compiling the Nation's infrastructure needs on a State-by-State basis. The study of New York State's infrastructure needs has been completed. Results of the study were discussed and analyzed at a congressional hearing I chaired in Albany last Sep-

tember 7. Included in the study were needed repairs to transit, sewers, waste water, rail, and airports.

The Joint Economic Committee found that the State's public works needs during the period from 1983 through 1987 are $43.1 billion. From 1983 through the year 2000 they amount to $108.8 billion.

Estimates of the cost for the entire Nation through the year 2000 range as high as $3 trillion. Clearly, the magnitude of the infrastructure problem is mammoth. This problem did not occur overnight. Declining funding of maintenance and refurbishment activities helped exacerbate the problem.

In many cases, local government was unable to finance the repair of its public works. If our bridges, roads, and water systems further deteriorate, both service and basic industries will be unable to expand. Industry will either decline or move abroad. In the end, jobs will be lost.

The crux of the issue is jobs. If New York cannot raise approximately $108 billion for infrastructure repair and replacement through the year 2000, the States will become an unsafe, uneconomic region. In short, municipal finance is not an irrelevant subject, but is the key to the future health of local economies.

Do your cities have the ability to raise the external funds necessary to repair their infrastructures and provide continuing services? Another way to ask this question is, "What is the current financial health of the nation's cities?"

This committee has just finished a survey of the fiscal condition of large- and medium-sized cities. The report concludes that 43 percent of the cities surveyed incurred operating deficits in 1982. This figure was anticipated to rise to 64 percent in 1983. For most cities, operating deficits are prohibited by statute and must be eliminated through budget cutting. Often essential services, such as police and fire, are the first to be trimmed. Clearly, the public health and safety is impacted by such actions.

The study found that smaller cities were in the greatest fiscal distress. Larger cities have better adjusted to the fiscal problems caused, in part, by shifts in their industrial bases and labor force. Cities with populations of between 50,000 and 100,000 incurred the greatest proportion of operating deficits. These jurisdictions were less prepared to adjust to the scissors effect of an eroded tax base coupled with a greater demand for local services. Consequently, in 1982, expenditures for those cities surveyed grew at an 8 percent rate, while revenues rose by only 6.3 percent.

The committee found that taxes rose while the use of debt fell. Sales and income taxes increased the most, while property taxes did not keep pace with the growth in property values.

The financial health of our cities definitely has declined. However, the need for future expenditures is staggering. The pressures on financial officials of local government will be enormous. Innovative techniques for raising funds will be required. But traditional sources of capital, in particular municipal bonds, will play a major role in external financing. Today, we will hear what shape existing avenues of municipal finance are in and how accessible they now are to local governments.

Now, I would like to call upon our first witness, Harrison J. Goldin, comptroller of the city of New York.

Let me simply say that when we talk about municipal finance and the cost of borrowing, we talk about saving the taxpayers money and building the infrastructure that will provide a safe environment in the State of New York.

The infrastructure requirements will be something in excess of $118 billion in New York by the year 2000. The cost of that financing then becomes of major concern.

One of the things that disturbs me greatly is that there is a lack of recognition by the Congress that local communities and States do not have the ability to have access to financing at reasonable cost.

The social security law that takes effect in 1984 would tax previously tax-exempt interest. This would be precedent for taxing all municipal bonds.

Individuals purchase 37 percent of all municipal bonds and 50 percent of those individuals are over the age of 65. The people who purchased these bonds and who have been earning lower interest rates and purchased them because they were supposed to be tax free now find themselves in a position where they are to be taxed.

I have heard the comptroller speak with strong objection to the provision that taxes tax-exempt interest and I thank him for supporting my bill that deals with this.

Thank you for being here to testify, Mr. Goldin, please proceed.

STATEMENT OF HARRISON J. GOLDIN, COMPTROLLER, CITY OF NEW YORK

Mr. GOLDIN. I appreciate this opportunity, Senator D'Amato, to testify on behalf of the city of New York on a number of matters that affect the city's ability to issue long-term and short-term debit.

Frankly, Senator, it comes with ill grace for an administration which rode into office as a champion of States' rights and individual rights, with the promise that it would reduce the burdens of the Federal Government on our daily lives, to pursue financing policies which actually increase the burdens on State and local governments. These burdens involve both costs and operations, and are ultimately passed on to the individual taxpayer.

These policies include the proposed imposition of volume limits on a State-by-State basis on the issuance of tax-exempt industrial development bonds; blanket restrictions on lease financing for equipment and real property used by State and local governments; proposed Treasury regulation, now happily backburnered for the time being restricting the short-term borrowing practices of States and cities, and the inclusion of tax-exempt interest earnings in determining the tax liability of social security recipients.

I am pleased to note that you, Senator, have authorized a bill to repeal the last measure. As you know, I actively support your bill. I regret that Congress has not yet seen fit to pass it; but I will do whatever I can to persuade the Congress to do so.

For it is a serious mistake to include tax-exempt earnings in an individual's income pool in determining whether social security benefits exceed the taxable threshold.

This measure concerns the entire municipal securities market and is sure to add considerably to the interest cost of State and municipal borrowers.

In effect, the measure taxes tax-exempt income. I hope your repeal bill is passed at this session in Congress. But if not, I plan to seek court relief, if that is feasible, on the grounds that counting tax-exempt income for social security purposes is unconstitutional.

I will speak to your bill in a moment.

First, I want to note that I join the Municipal Finance Officers Association of America in its opposition to volume caps on the issuance of tax-exempt industrial development bonds.

Certainly, there are instances in which local tax exemption has been assured and I support restrictions on such abuses. But comprehensive State-by-State volume caps on industrial development bonds constitute throwing the baby out with the bath water. It makes no sense to impose avoidable restrictions on localities that desperately need economic development financing nor is it reasonable to impose more unnecessary reporting and administrative requirements on State and local officials.

Moreover, the proposal does not distinguish between development bonds issued to finance ports, airports, and other clearly public purpose projects and bonds which simply provide cheaper financing to provide developers for their own purposes. Thus, I agree fully with the objections of the Port Authority of New York and New Jersey to the proposed volume caps.

By the same token, I oppose the proposed blanket restriction on all lease financing for equipment or real estate used by local governments. The proposal does not distinguish between uses of lease financing that are in the public interest and the abuses which Federal officials say exist.

The MFOA estimates that should this proposal pass Congress, the cost to States and local governments of leasing most equipment would increase by 13 percent, but remain the same for the private sector.

Take one example: Why should a commercial landlord lease office space to public agencies if, by renting to private tenants, he can get certain tax benefits no longer available to the State and local governments that seek to rent his property?

Then there is the regulation that Treasury proposed last spring; it would have seriously handicapped a city's ability to maintain reasonable cash balances. The regulation would have required a municipality to project an actual deficit before being able to issue tax or revenue anticipation notes; it would have limited the amount of such notes to the projected cumulative deficit, plus 5 percent.

New York City's bond counsel, Rogers & Wells, sent a carefully reasoned objection to the Internal Revenue Service. It explained that the proposed amendment to the Treasury's arbitrage regulations would have required unrealistically precise municipal cash flow forecasts and might force cities into the marketplace under adverse market conditions.

Fortunately, these arguments impelled the Treasury to withdraw the proposal, at least temporarily; but we do not know whether it was killed outright. In fact, we have some reason to believe that it may reappear in somewhat different form.

And now, Senator, we come to the measure which your bill would repeal; namely, the inclusion of tax-exempt interest earnings in determining the tax liability of social security recipients.

The requirement should be repealed because it meets neither of the two objectives usually cited in its defense; namely, to provide more revenue for the financially troubled social security system and to distribute fairly the burden of bailing the system out of its difficulties. Indeed, the requirement is actually unfair and damaging to States and local governments throughout the country.

On the first point, the estimate is that including tax-exempt earnings in the determination of the tax liability of social security recipients will net the Federal Government only $5 million over the next 7 years. That averages annually to an extra $700,000 in a Federal budget that already exceeds $800 billion and is expected to be more than $1 trillion in a couple of years.

Seven hundred million dollars is nine hundred millionths of the Federal budget; that is a decimal point followed by seven zeros and a nine. That proportion would not pay for three shakes of a saltshaker into a 20-gallon kettle of soup.

So much, I think, for the added revenue argument. Neither the Federal Government nor the social security system would be adversely affected by the passage of the D'Amato bill to repeal the indirect tax on earnings from municipal bonds.

The second point is the fairness argument; namely, that super wealthy recipients of social security benefits would switch taxable earnings into tax-exempt municipals, if the D'Amato bill passes, just to be able to beat the tax on half their social security benefits. The point is laughable.

Those of the rich elderly whose income already consists exclusively of interest from tax-exempt municipals plus a, for them, negligible amount of social security benefits are extremely few in number. To try and catch these few in a Federal tax net at the expense of the municipal bond market and at enormous cost to States and local governments and their taxpayers is like amputating an entire arm at the shoulder to cure an arthritic finger.

Should your bill pass, Senator D'Amato, those rich elderly whose income is taxable would not likely switch to tax-exempt in order to avoid payment of taxes on half their social security benefits. As your convincing analysis in the Congressional Record showed, Senator, the commission payments they would incur in the switching transactions would far outweigh any tax savings; a switch to avoid a small amount of tax would be foolish in the extreme. The fairness argument for taxing tax-exempts in these circumstances simply does not apply.

Indeed, fairness requires us to oppose the indirect tax on municipal bond earnings, because only the elderly are taxed. Those who do not receive social security benefits pay no Federal taxes at all on their municipal bond earnings. Hence, the law which your bill seeks to repeal is clearly discriminatory against the elderly.

The situation, then, is this: the direct tax on municipal bond earnings discriminates solely against elderly bondholders; it neither bails out the social security system nor brings the Government a lot of new revenue. Nor does it promote equity by taxing wealthy social security recipients more.

I oppose the indirect tax on those grounds alone. But I have an even more compelling reason. With the direct tax on social security benefits correctly perceived by individual investors as an indirect tax on higher to completely tax-free securities, the market for bonds sold by States and local governments is sure to be affected in an understandable and predictable way. Issuers of new municipal bonds can anticipate having to pay more interest when they borrow and millions of existing bondholders will see the value of their bonds decline somewhat.

The reason is clear: even though this indirect tax on tax-exempt municipal bonds affects relatively few bondholders directly, it adds an element of uncertainty to the municipal securities market. And, if there is an ironclad rule in the marketplace, it is that uncertainty puts the seller at a disadvantage, with buyers exacting higher interest that is roughly proportional to the degree of uncertainty.

To be sure, a negative certainty can sometimes be worse. Assume, for the sake of argument, that the Federal Government nullified completely the tax exemption on municipal bonds and notes. Such securities would now be fully taxable by Washington, a clear certainty. That would today cost municipalities an additional 3.5 percentage points in net interest cost on bonds and notes they issue. To illustrate: a tax-exempt, 10-year "Baa" bond today pays interest at about a 9-percent rate; at the same time, a taxable bond with comparable maturity and rating pays about 12.5 percent.

That the tax in question at this hearing is indirect and not across the board supposedly leaves the principle of tax exemption intact at least according to proponents of the tax. Even were this true, which I deny, the element of uncertainty imposes higher borrowing costs on all States and municipalities in the Nation.

What is that uncertainty? Here we speak in terms of investor psychology, rather than empirical, scientifically verifiable fact. But I believe it reasonable to assume that a 60-year-old investor with $50,000 worth of New York City bonds would feel suddenly insecure in realizing that 5 years from now, when he retires, he could lose half his social security benefits.

Another uncertainty is this: If the Federal Government can impose this particular indirect tax on tax-exempt bond earnings, what prevents it from seeking other "indirect" taxes the next time the social security system needs cash?

In other words, if the D'Amato bill does not pass, many current municipal bondholders will get out of the tax-exempt market altogether, while many others not in it now will no doubt be advised by their brokers or investment counselors not to get in, unless the returns are worthwhile enough to offset possible losses arising from Government action in the future.

How much of a premium will states and municipalities have to pay to continue selling securities whose tax exemption is no longer completely sure?

Well, the Municipal Finance Officers Association, the MFOA, conservatively estimates the higher interest cost at between a quarter and a half of 1 percent.

For all 50 States and their localities that comes to an additional interest cost of between $300 million and $600 million. That quarter of

a percent represents an awful lot of police officers, sanitation workers, and street repairmen.

In New York State alone, the MFOA estimates the extra interest cost at between $21 million and $42 million a year. In New York City I estimate that by 1986, when the city will be wholly independent of the Municipal Assistance Corp. in raising $1.1 billion on its own faith and credit, the extra interest cost will range between $23¾ million and $51½ million a year.

Extrapolating that over the next 10 years and assuming that the city meets its ambitious 10-year capital construction program (we are talking about issuing more than $2 billion of city bonds a year), the extra interest cost—half of a percent in the MFOA's worst scenario—would amount to $10 million a year on just the bonds issued in a single year. Assuming an average 10-year life for the bonds issued each year, that comes to $100 million in extra interest on the bonds issued each year. On all bonds issued during the entire 10-year period, the extra interest is a staggering $1 billion.

And for what? Just so the Federal Government, in a wholly misguided and erroneous attempt at fair play, can compel a relative handful of social security recipients to pay income tax on half their social security benefits. It does not make sense. And we do not need it.

Moreover, adding in tax-exempt income in order to determine the taxability of social security benefits is, in my opinion, unconstitutional. I have consistently referred to this tax as an indirect tax on tax-exempt income. But the Public Securities Association argues flatly that:

> The use of a specific income to determine tax liability is the economic equivalent of a direct tax on such income.

Direct or indirect, the tax is unconstitutional because it violates the Constitution's 10th amendment. Under that amendment:

> The Powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.

When the Constitution was first adopted, each of the Thirteen Original States already had the power to borrow funds for its own governmental needs. Over time the courts have held that the Federal Government cannot restrict this power in any way. Moreover, a case decided by the Supreme Court of the United States has established that Federal taxation of the interest earnings from State and local bonds restricts the States' power to borrow, a restriction prohibited by the 10th amendment. The pertinent case is *Charles Pollock* v. *Farmer's Loan & Trust Company* (1895), interpreting the "reciprocal immunity" doctrine under which the 10th amendment deprives Congress of the power to tax interest on State and municipal obligations; similarly, States cannot tax the interest on Federal securities.

By logical extension this analysis prohibits the inclusion of tax-exempt income for determining tax liability elsewhere. Hence, the statute which the D'Amato bill seeks to repeal is an unconstitutional restriction on the power of State and local governments to borrow.

I have directed by General Counsel to study the feasibility of my bringing suit as comptroller of the city of New York to prevent the Federal Government from enforcing this unconstitutional provision on the social security law.

If it is feasible, I plan to institute a class action to insure that States and municipalities are not burdened with extra interest costs by a silly tax provision.

If the D'Amato bill repealing this provision is passed by both Houses of Congress and signed by the President, such litigation would be moot. Enactment of our bill, Senator, would be preferable and simpler than a court case.

One final point. Because our State and city income taxes are coupled with the Federal income tax respecting the determination of adjusted income, both State and city are caught in a curious irony: They, too, are indirectly taxing tax-exempt interest generated by their own bonds and notes.

I believe the State legislature should uncouple both the State and city taxes from the Federal tax in this regard, as a contingency measure in the events that either the D'Amato bill is not passed or that my court action is not completed in time to make the indirect tax inapplicable to 1984's tax returns. Thank you.

Senator D'AMATO. I want to thank you not only for your participation and support of the legislation which I have introduced along with 17 or 18 other colleagues in the Senate, but also for the depth and scope of your presentation today. Your presentation was serious and thoughtful.

If my bill, S. 1113, is not enacted, I would gladly join you in a class action suit. Clearly, taxing municipal bonds is a constitutional question. That might be a rather unique endeavor having both a U.S. Senator and a city comptroller joining in a suit against the Government.

Let me simply say that I think the Koch administration has done an excellent job in dealing with the fiscal dilemma that the city has faced. I look forward to working with you and the mayor in strengthening that fiscal base. Thank you, Mr. Comptroller for your presentation.

Our next witness is our deputy mayor in charge of finance and economic development.

Let me thank you, Mr. Deputy Mayor, for your participation today. As I have indicated to the comptroller, I believe that this administration has much to be proud of in leading the city to a position where we now talk about what will be done with the billion-dollar surplus as opposed to where the additional funds will take place. That is a nice thing to be battling over, how best to allocate the billion dollars rather than trying to find the sufficient funds to continue the administration. Please proceed.

STATEMENT OF KENNETH LIPPER, DEPUTY MAYOR FOR FINANCE AND ECONOMIC DEVELOPMENT, CITY OF NEW YORK

Mr. LIPPER. Thank you for the help that you have been to the administration in helping us come to the long distance in the fiscal crisis.

I am Kenneth Lipper, Deputy Mayor for Finance and Economic Development of the city of New York.

I welcome the opportunity to testify today on the challenge now facing the Nation's cities of financing their capital needs and the proper Federal role in this critical area. Our history here in New York City, whose bonds are again rated as investment grade after

being closed out of the credit markets during the fiscal crisis, has given us firsthand experience in the financing problems facing our cities.

Let me begin by stating the city of New York's support for S. 1113, which would repeal the inclusion of tax-exempt interest earned from municipal securities when calculating the tax liability of social security recipients.

Section 121 of the Social Security Act of 1983 provided that benefits were to be taxed if the recipient's income exceeded $25,000 for an individual or $32,000 for a couple. However, the act required that interest from tax-exempt municipal securities be counted as income. This is, in effect, a tax on the interest from previously tax-exempt municipal securities, since including interest from municipal obligations as income increases the tax liability of recipients who are just below the threshold.

We support S. 1113, which would repeal this provision, for several reasons. First, only social security recipients are required to report their tax-exempt income and only those middle-income recipients who are just below the threshold will owe more tax as a result. Further, the provision is retroactive. It applies to municipal bonds purchased previously in the belief that interest earned would be completely free from tax. This provision amounts to a confiscation of property since investors have already paid for the tax-exempt feature of municipal bonds by accepting a lower rate of return.

Equally disturbing is the negative signal this provision sends to the municipal market. The tax-exempt nature of municipal bonds allows municipalities to offer lower rates than are available in the taxable market. By chipping away at the previously sacrosanct nature of the tax exemption on municipal bonds, the Social Security Amendments of 1983 established a dangerous precedent. In the future, any individual who purchases a municipal bond cannot be certain that future legislation may not make his interest income subject to tax. This perception of uncertainty with regard to the tax-exempt nature of municipal bonds will tend to make investors demand higher yields and thus tend to raise the cost of borrowing for cuties. Although it is difficult to predict with certainty the effect on tax-exempt rates, it is clearly a step in the wrong direction. For these reasons, the city of New York urges the passage of S. 1113, which would repeal this provision.

The negative signal which the Social Security Act of 1983 sent to the municipal markets could hardly have come at a worse time. Like other borrowers, municipalities are now facing some of the highest real estate rates in history. In 1977 and 1978, the real interest rate on municipal bonds, that is, after subtracting the inflation rate, was near zero. For a time the real interest rate was negative, with inflation in double digits while municipal rates ranged between 7 and 9 percent. In the last few years, however, long-term municipal rates have remained near 10 percent even as inflation has been brought under control. The result has been an increased real cost of capital to cities, with real rates at an historical high.

Competition from Treasury borrowings needed to fund the $200 billion Federal deficits has surely contributed to these high real interest rates. And it is not simply the current size of the Treasury's credit needs. It is also that these enormous deficits are projected to persist despite a continuing economic recovery and an increasing demand for credit from the private sector.

On a less practical, but critically important note, what does it say about American society and culture, that we choose to discriminate in taxation against our old folks, those who contributed so generously to our current stability and prosperity. Is it now the American way to squeeze pennies from the weak and defenseless rather than courageously attacking the current disaster of a hemorrhaging budget?

Rather than acting to strengthen the municipal markets, recent changes in Federal tax law have had precisely the opposite effect, making tax-exempt bonds less attractive. The need for commercial banks and other corporations to invest in municipal bonds has been reduced by legislative changes, including the Economic Recovery Tax Act of 1981, which allowed the accumulation and sale of tax benefits through leasing arrangements.

In addition to such possibilities, declining profits in the fire and casualty industry left these major participants in the municipal market with less income to shelter.

The result has been the virtual disappearance of institutions from the municipal market. Municipal yields rose to attract individual investors who, in 1982, purchased 87 percent of new municipal issues. The long-term trend has thus been for a narrowing interest rate differential between tax-exempt and taxable debt. Traditionally at 60 percent, in 1982 the spread disappeared entirely and now stands at an historically high 85 percent.

I would like to describe the importance of a healthy municipal market for New York's capital plans. Like many other cities, for years, New York City allowed its infrastructure to deteriorate. The state of our mass transit facilities and the condition of many of our roads and bridges are the result of that neglect. Since 1978, we have reversed this trend. We have made infrastructure repair a priority and have initiated $6.4 billion in capital projects. We have resurfaced or reconstructured almost 3,000 miles of streets, rebuilt 48 bridges, invested $800 million in water pollution control plants to improve our environment and committed over $500 million in city funds to a third water tunnel to insure a safe, adequate water supply for New York City.

Despite these achievements, much more remains to be done in order to put our infrastructure in good working order. We still have too many potholes and suffer from too many water main breaks.

We have therefore developed the most comprehensive capital plan of any State or local government in the Nation—a 10-year, $35 billion program to repair our bridges, streets, sewers, and water supply system.

The ability to finance this program at interest rates we can afford is critical to its success. In the next 4 years, the city and the municipal Assistance Corp. will be issuing $7.9 billion in debt in order to undertake capital projects and pay down our federally guaranteed debt.

New York City will spend $1.8 billion—10.7 percent of our budget—on debt service in the next fiscal year, and most of this goes to interest payments. In comparison, we spend $950 million, approximately one-half this amount, annually for police. The level of services we can provide depends in large part on the health of the municipal market. The interest rates we must pay in order to repair our infrastructure directly

affects the number of police, fire, and sanitation workers the city can afford.

In a time of a weakening market for municipal securities, the Federal cuts in aid to localities have hurt the underlying credit of our cities. A survey of 299 cities by your committee found that Federal operating aid declined by over 10 percent in 1982 alone and projected a further decrease in 1983. It also found that 43 percent of the cities surveyed ran operating deficits in 1982.

The Nation's economic recovery has predictably improved the operating budget of the Nation's cities, and many bottom lines have turned from red to black. But this phenomenon is cyclical, and we must also not forget that the long-deferred costs of repairing the Nation's deteriorating infrastructure are not reflected in these budgets.

A measure of the worsening credit of our cities is provided by their declining credit ratings. Downgrading of municipal ratings by Moody's increased from 171 in 1981, to 263 in 1982, and 291 last year.

Federal cuts in aid have left the Nation's cities with the same housing and infrastructure problems as before, but simply with less ability to solve them. New York City has already traveled the painful road that other cities are now beginning. We know the choices these cities will face as a result of reduced Federal aid, high interest rates, and continued severe unemployment.

Reduced Federal aid has led cities to rely increasingly on the tax-exempt market as their only option to fund their capital needs. In fact, long-term municipal debt has increased by 60 percent in constant dollars just since 1981. It is in this context that current proposals to restrict the availability of tax-exempt financing are so disturbing.

Housing provides a prime example. The lack of housing is one of the critical problems New York City faces—79,000 rental housing units in New York City are in such poor condition that they are classified as dilapidated. Not only do we have a large stock of units requiring rehabilitation, we also face a fundamental problem of affordability. For 72 percent of the city's families who live in rental housing, the median income was only $11,000 in 1980. The result is that 31 percent of the city's tenants pay more than 40 percent of their income for rent and utilities.

In addition to the problem of providing adequate low-income housing, expanding home ownership opportunities for our middle class is essential to New York City's continued economic health.

In 1970, commuters were 15 percent of New York City's work force. We have had a long-term trend toward increased commuting, and today commuters are estimated to hold over 20 percent of our jobs. This trend is a source of concern, for it threatens to erode our fiscal base, since commuters contribute less in taxes to the city than do residents. There can be no doubt that the lack of affordable middle-income housing is one important reason for this trend.

Yet despite our critical need for more low- and middle-income housing, Federal housing aid to New York City has been cut by $600 million from 1982 to 1984. Nationwide, Federal programs to assist low- and middle-income housing have been cut in half since 1980 from approximately $26 billion to $13 billion. Housing programs have experienced some of the largest cuts, in percentage terms, of any Federal programs.

Though its funding was modest, the Housing and Urban-Rural Recovery bill which was passed last year was important, both as a new initiative and for its recognition of the Federal responsibility in this area. I want to thank Senator D'Amato for the key hole he played in its passage.

Through a variety of innovative programs, New York City is attempting to fill the gap left by the Federal housing cuts as best we can. Tax-exempt financing is the only vehicle remaining to New York City in order to produce low- and middle-income housing. We are therefore extremely concerned by the legislative proposals to restrict access to tax-exempt financing.

The authority to issue tax-exempt mortgage bonds for single-family housing expired on December 31, 1983. We urge the immediate passage of legislation to extend this authority. An extension is essential to two of the city's most important projects to construct affordable single-family housing for families earning less than $30,000. Without tax-exempt financing, mortgage costs would escalate and put these homes out of reach of the moderate income residents we are trying to help.

In a successful public/private partnership, the city and the New York City partnership, a coalition of business and civic organizations, is planning to build 5,000 single-family homes throughout the city over the next 5 years. This program is being aided by an urban development action grant, the donation of city-owned land and city-funded infrastructure improvements. It will provide the opportunity of home-ownership to families earning as little as $25,000. This initiative cannot be successful unless the State of New York Mortgage Agency has the authority to issue tax-exempt financing.

Another example is the Nehemiah project, sponsored jointly by the city and a coalition of churches, which will build another 5,000 single-family homes in the east New York section of Brooklyn. The city is providing interest-free loans of $10,000 per home in order to reduce the mortgage principal and make these homes affordable to families with incomes between $20,000 and $30,000.

This project will not only provide vitally needed housing, it will also enable the residents of one of the city's most distressed areas to begin to rebuild their neighborhood. Again, this project will not be possible without tax-exempt financing.

We were extremely happy to see that H.R. 4170, which contained a ceiling of $150 per capita on industrial development bond financing, did not pass the House of Representatives last year. We would urge that this cap on industrial development bond financing be deleted when the bill is reconsidered this year.

There are two problems with the proposed industrial development bond cap. First, by making allocation to the States, an additional layer of Government is placed between local governments and their ability to set priorities and finance their needs.

Further, the proposed cap fails to take into account New York City's needs in the years ahead and could force us to choose between equally critical projects. We estimate that, under H.R. 4170, the city would be authorized to issue only about $480 million in industrial development bond financially annually.

An exemption from the cap for multifamily housing, which was approved as an amendment to H.R. 4170 by the Ways and Means Com-

mittee, was a major improvement. New York City has plans to issue $300 million in industrial development bonds in 1984 for multifamily housing alone. Tax-exempt financing is essential to our plan to use $100 million in surplus Municipal Assistance Corp., funds in order to leverage hundreds of millions of dollars in private funds to produce affordable low- and middle-income housing.

Despite this exemption, New York City has preliminary plans which indicate we need an additional $500 million in industrial development bond financing in 1984—$400 million for resource recovery facilities and $100 million for economic development projects. Thus, our current needs are already greater than the proposed cap and could be even larger in the future.

Let me describe what this legislation could mean for New York City's efforts to find a solution to its pressing waste disposal problem.

Our Fresh Kills landfill will soon have to receive the 22,000 tons of refuse disposed of in the city each day. At that rate, the capacity of Fresh Kills will be exhausted in 15 years. Lack of space and environmental regulations make it impossible to site new landfills within the city. Disposal of waste outside the city is not possible due to restrictions understandably imposed by other municipalities.

We have addressed this problem by developing plans to build resource recovery plants through the use of industrial development bonds. Resource recovery offers the best alternative to our existing methods of waste disposal, because it reduces the volume and weight of refuse while recovering energy.

These projects are extremely costly. The Brooklyn Navy Yard project, scheduled for financing this year, will handle 3,000 tons per day and will require a bond issue of $400 million. Our projections indicate that during the next 5 years we will have to construct resource recovery facilities to process 10,000 tons per day, and that an additional 10,000 tons of daily capacity must be constructed after 1988. We estimate that the cost of our 10- to 15-year proposed resource recovery program will be in excess of $2.5 billion in today's dollars. Further, according to Internal Revenue Service regulations, any financing for resource recovery must satisfy all industrial development bond regulations. A statewide cap will place our waste disposal program in competition with every other project eligible for industrial development bond financing.

Another aspect of H.R. 4170 would be particularly damaging to New York City's resource recovery program. Under the program, the private contractor who constructs and operates a resource recovery facility will make a cash contribution to the city of approximately 25 percent of the project cost. The basis for this contribution is the accelerated depreciation and investment tax credit the private contractor can receive. Under the bill, however, the private contractor would not qualify for these tax benefits. The city would thus lose the cash contribution, and the cost to the city of constructing a resource recovery facility would rise substantially.

Finally, there are the small-issue industrial development bonds used to promote economic development. A statewide cap could limit our ability to continue to help companies remain and expand in New York City. We could be forced to choose between expanding our economic base and such a fundamental need as waste disposal.

In a time of Federal cuts, industrial development bond financing is now one of the only financing resources available to municipalities. Though less direct and efficient than Federal revenue sharing, it has the advantage of being controlled at the local level. With Federal policy moving away from direct aid to localities, current proposals to allocate to the States a maximum amount of industrial development bond financing would reduce local control and limit one of the last resources which cities have left to address their problems. Thank you.

Senator D'AMATO. Let me thank you again for taking your time and for your strong presentation, which is part of this record. The provision taxing municipal bonds only hurts the middle class not the wealthy.

This provision raises a total of less than $1 million a year, and then comes back to hurt the local municipalities by costing a minimum of some $250 million a year.

As the Comptroller had pointed out, this bill does not affect the very wealthy and it comes down and hurts those within the $25,000 income range.

Mr. LIPPER. Thank you very much, Senator.

Senator D'AMATO. Jack Guildroy, chairman of the New York State Legislative Committee for the American Association of Retired Persons, and Mr. Jack Elkin from the National Commission on Urban Affairs, American Jewish Congress.

Mr. Guildroy.

STATEMENT OF JACK GUILDROY, CHAIRMAN, NEW YORK STATE LEGISLATIVE COMMITTEE, AMERICAN ASSOCIATION OF RETIRED PERSONS

Mr. GUILDROY. My name is Jack Guildroy, and I am here today on behalf of the 15 million members of the American Association of Retired Persons, the Nation's largest aging organization. I am chairman of AARP's New York State Legislative Committee which represents over 1,300,000 New York members, and I am also a member of AARP's National Legislative Committee. I am pleased to have the opportunity to appear before this committee to discuss tax-exempt income and social security.

One of the inequitable characteristics of the 1983 social security amendments is the inclusion of interest earned on tax-exempt bonds in computing the amount of social security benefits to be taxed. Legislation proposed by Senator D'Amato, S. 1113, would correct this inequity in the social security formula. This would be a fair initial change in the social security package with little adverse impact on solvency.

During consideration of the recent social security amendments, the association, with the help of its members and volunteer leaders, worked hard to secure more adequate financing for social security in order to better assure the system's short-term solvency. AARP also sought to make the short- and long-term remedies more fair and equitable in their treatment of both social security recipients and taxpayers in order to minimize any harsh effects on low-income persons and assure continued worker support for the program. It is AARP's belief that the social security system could be strengthened by changes such as

the addition of nonpayroll tax revenue, lessening of the steep payroll tax increases and the provision of work incentives for the long term, as well as by a deletion or modification of the taxation of benefits provision.

When Congress enacted the recent social security financing package, it represented the second attempt in 6 years to meet a large and imminent financing crisis in social security's cash benefit programs. For the next 7 years, the social security package will provide trust fund contingency reserves only equal to approximately 2 months' worth of benefits—even less than the slim reserves with which social security has had to operate over the past few years. These dangerous low reserve levels will mean that any slight worsening in expected economic conditions (that is, higher inflation and/or higher unemployment) could cause social security to face another short-term financing crisis—one which would take a severe toll on public confidence in the system and one which could trigger more substantial reductions in the program's benefit protections.

Any recurring short-term financial problem in social security should not be resolved in ways that would once again penalize older persons who are already on the benefit rolls or who will be reaching beneficiary status in the near future. Given the elderly's precarious income situation, the magnitude of the inflation and benefit losses they have already sustained and lack of options they have to offset benefit losses, they not be asked to bear further large benefit reductions.

Rather than continue to burden the elderly, if necessary, Congress should cushion the system by temporarily identifying nonpayroll tax sources of revenue and earmark sufficient revenue from such sources for the social security cash benefit programs. In order to avoid increasing the Federal budget deficit, any revenue used for social security purposes must come from either a reduction in other Government spending of lower priority or from additional nonpayroll taxes.

For the first time, the 1983 Social Security Amendments subject up to one-half of social security benefits of certain individuals to Federal income taxation. This represents a fundamental and detrimental change in the system. The association vehemently opposes taxing social security benefits since in the short term it abruptly changes the rules of the game on current beneficiaries and defeats the reasonable benefit expectations of people approaching retirement. For the long term, taxing benefits represent a back-door means testing of the program and a substantial reduction in benefits particularly for future retirees.

In the near term, an estimated 2 to 3 million social security recipients whose modified adjusted gross incomes (including one-half of their social security benefits) exceed $25,000 for an individual and $32,000 for a married couple, are being subjected to the increased tax burden. Now that a precedent has been set, these $25,000/$32,000 thresholds could easily be lowered by legislation in the near future since social security is very likely to face further financing problems and be in need of additional revenue. Given the precedent, no one's benefit will be safe from recapture via the income tax system.

Within this framework of taxation, and increasingly detrimental is the inclusion of interest earned on tax-exempt bonds in determining of interest earned on tax-exempt bonds in determining the amount of

modified adjusted gross income which exceeds the threshold amount. This additional income will push even more elderly over the threshold amount. An estimated 7 to 8 percent of current social security recipients whose modified adjusted gross incomes exceed the $25,000/$32,000 threshold will be subject immediate to the increased tax burden in 1984. Specifically, the amount of the benefit subject to taxation would be the lesser of either one-half the social security benefit or one-half the amount by which the taxpayer's combined income (AGI plus one-half of the social security benefit plus interest earned on tax-exempt bonds) exceeds the $25,000/$32,000 thresholds. By 1990, however, due to planned increases in social security and the normal growth in incomes, about 25 percent of the social security population will be subject to this tax.

AARP believes that inclusion of interest from tax-exempt bonds causes some social security recipients to be treated less favorably by the tax system than all other taxpayers. While tax-exempt interest is used to determine additional tax liability for social security beneficiaries, it is entirely ignored by all other taxpayers for personal income tax purposes. The law effectively classifies only certain individuals receiving social security, usually those near the threshold amounts, and singles them out for disparate treatment with respect to tax-exempt income. These middle-income elderly individuals are the only persons who are denied the full benefits of tax-exempt interest. It is unfair to place the greater tax burden on this one elderly segment of our society. In practice, a person who receives no social security and $10,000 of tax-exempt interest is not required to use this interest to move himself or herself into a higher tax bracket. However, $10,000 of tax-exempt interest could significantly raise the tax liability of a social security recipient.

The tax-exempt interest rule will generally only affect people near the threshold amounts, and since the threshold phases out quickly, many people with incomes above this amount will pay tax on the statutorily mandated one-half of social security benefits regardless of the tax-exempt income provision. Those close to the threshold who have tax-exempt income are those who are harmed by the unequal treatment of the current tax provision, and the greatest burden from the present law would fall on persons whose incomes are barely over the threshold. For example, an individual with a pension of $20,000, one-half social security benefits of $4,300 and bond income of $5,000 (total: $29,300; $24,300 without bond interest), would owe about $550 more in Federal income taxes because bond income is included.

In addition, it is necessary to consider that those who purchased tax-exempt bonds did so specifically in reliance on receiving the tax benefits provided by these bonds. The change promulgated by the social security taxing formula frustrated the buying purpose of those affected. Now, not only have the tax benefits been lost, but certainly elderly individuals must bear an additional tax burden.

AARP thus wishes to express its support for S. 1113, which would correct one of the inequities of the taxation of benefits provision by prohibiting the inclusion of income from tax-free bonds in calculating the amount of social security benefits to be taxed. While AARP strongly advocates an entire repeal of taxation of benefits, S. 1113 is an ap-

propriate step that can be taken at virtually no cost to the social security trust funds.

Senator D'AMATO. Thank you very much, Mr. Guildroy, for coming in and your very strong support of S. 1113. I will look very carefully to the suggestion that you have made with respect to the Social Security Act as it presently exists.

Mr. GUILDROY. Thank you.

Senator D'AMATO. Mr. Elkin.

STATEMENT OF JACK ELKIN, NATIONAL COMMISSION ON URBAN AFFAIRS, AMERICAN JEWISH CONGRESS

Mr. ELKIN. The American Jewish Congress, a national organization of American Jews, welcomes this opportunity to present its views on the proposed repeal of the law providing for the inclusion of tax-exempt interest in determining whether a social security beneficiary reaches the adjusted gross income threshold at which half his benefits will be subject to the income tax. The social security system has been a priority concern of our organization for the following reasons:

1. The Jewish tradition teaches us that a society must be judged in part by the manner in which it treats its aged and needy members;

2. The 15 percent of American Jews who are over age 65, a figure which is growing, is far greater than the 11 percent of the general population which is over that age;

3. Unlike American society in general, where most of the poor are younger people, among Jews the poor are predominantly elderly. For most of them, social security is their major source of income.

Our work in the social security area has included testifying before legislative and executive bodies, sponsoring an information and referral service to increase the awareness of the elderly about benefits to which they may be entitled and publishing information regarding public policy issues that require action. Additionally, at the request of the Social Security Administration, we have translated documents into Yiddish and aided in the distribution of pamphlets describing the supplemental security income (SSI) program.

The social security amendments of 1983 included a provision which provides for the taxation of up to one-half of the social security benefits received by a single taxpayer whose adjusted gross income exceeds $25,000, by married taxpayers filing jointly whose adjusted gross income exceeds $32,000 and by married taxpayers filing separately whose adjusted gross incomes are greater than zero. If these threshold amounts are exceeded, additional computations determine the amount of social security benefits which will be taxed.

Of particular interest in the context of these hearings is the definition of income used for determining these base amounts. This includes taxable earnings, half of social security benefits and tax-exempt interest income.

The American Jewish Congress favors S. 1113, which would repeal the Senate-initiated provision that mandates the inclusion of income from tax-exempt State and local government bonds in determining whether social security beneficiaries reach the base at which half their benefits will be taxed. We take this position because the current law: (1) discourages the purchase of tax-exempt securities and increases

State and local financing costs; (2) discourages investment by small investors; (3) is difficult to implement; (4) is partially based on a fallacious understanding of equity; (5) has no effect on the wealthy; and (6) creates a marriage penalty.

Prior to elaborating on the reasons for our position, let me note that American Jewish Congress' interest in the financial well-being of social security is clear and we were supportive of the National Commission on Social Security Reform's compromise package. In our testimony before both the House Ways and Means Committee and the Senate Finance Committee, we announced this support in spite of the fact that we disagreed with particular provision in the legislative package.

First. The purchase of tax-exempt bonds will be discouraged by including their interest in determining whether a taxpayer has reached the level at which half of his social security benefits will be taxed. American Jewish Congress does not have a position on whether the provision in question is a tax on "tax-exempt interest." What is clear is that the provision uses the income from historically tax-exempt instruments in determining whether or not the social security beneficiary reaches the threshold at which half his benefits may be taxed. To make these bonds attractive in a competitive market, issuers will be required to offer higher interest rates.

This is especially the case since other untaxed income, such as dividend exclusions and capital-gains exclusions, are not computed in determining whether a social security beneficiary reaches the level at which half his benefits may be taxed. Moreover, other legislation also has lessened the attractiveness of municipal bonds. I am here referring to such measures as the decrease in personal income tax marginal rates, particularly the lowering of the top bracket rate on earned income to 50 percent; the reduction in the capital-gains rate which makes equity investments more attractive; and, the creation of federally guaranteed All-Savers Certificates. Furthermore, the provision discussed may also increasee borrowing costs by suggesting to some potential purchasers of tax-exempt bonds that these instruments may, in the future, not be totally successful in avoiding taxation.

Forecasts of the amount of money that will be lost or gained by this legislation are imprecise. The Municipal Finance Officers Association suggests that it will lead to a quarter to a half of 1 percentage points rise in the municipal bond market interest rate. According to their calculations, this totals extra expenditures of $299 million to $599 million a year.

This increase will occur in a period in which borrowing costs are unusually high and State and local governments are attempting to address substantial infrastructure needs. With many local governments, and more than a few States, already hard pressed to meet their budgets, higher financing costs will, we fear, lead to cutbacks in services or increases in State and local taxes and user charges.

Second. The provision under discussion also discourages small investors from participating in the tax-exempt market and encourages purchases of such securities by the wealthy. Government policy should encourage, not discourage, small investors from purchasing State and local government bonds. Giving small investors a direct financial stake in the operations of local governments and projects encourages them

to remain actively involved in overseeing government operations. This is a goal that all of us should support.

Third. The Internal Revenue Service's implementation of the new provision will be complicated and costly. The formula used in determining whether the social security beneficiary is subject to the tax is relatively complex and requires additional lines on income tax forms (social security beneficiaries are the only taxpayers required to include the income from tax-exempt bonds in computing tax liability).

With more than a few States using the Federal calculation of adjusted gross income in determining State and local income taxes, some owners of tax-exempt securities may end up paying State and local taxes on this income. To avoid this, it will be necessary to revise our nonfederal income tax laws by passing the State legislation to omit tax-exempt income in determining adjusted gross income.

Fourth. Equity is sometimes offered as a reason for maintaining the recently adopted provision. According to this view, passage of S. 1113 would lead to the wealthy escaping taxation of half their social security benefits by switching taxable investments into tax-free instruments, thereby bringing their income below the threshold level.

From a financial perspective, switching from taxable to tax-exempt investments would not make sense since it would take several years before the benefits of this substitution are outweighed by the brokerage costs of buying and selling these securities. Another problem with this view is that someone with, for example, $50,000 in tax-exempt income would, most likely, have enough taxable income to bring him above the $25,000 income threshold. The reason for this is that $50,000 in tax-exempt income would, at 10 percent interest, mean an investment of $500,000 in tax-exempt securities. It is unlikely that an investor with such an extensive tax-exempt portfolio would not have a pension and other income that place him above the $25,000 income threshold.

There is yet another problem with the view that the wealthy will escape taxation by converting taxable securities into tax-exempt bonds. By bringing taxable income below $25,000, the purchase of tax-exempt bonds loses its significance because marginal tax rates will become so low that tax-exempt bond become a poor financial investment. This is so because tax-exempt bonds pay approximately 3 percentage points less interest than equivalent grade Federal or corporate bonds.

Fifth. The provision in question is not relevant to wealthy social security beneficiaries, but only to those who are middle income. Some affected holders of tax-exempt securities are widows and were formerly in higher tax brackets. They often maintain tax-exempt securities, even though doing so makes no financial sense because they are in lower tax brackets than when these investments were made. For example, if a person has $100,000 of adjusted gross income and $20,000 of tax-exempt bond income, he would pay the tax on one-half of his social security benefits. At this income level, whether he had $1,000 or $10,000, or the $20,000 in tax-exempt interest cited, would make no difference since the beneficiary will have reached the threshold level at which he is obligated to pay income taxes on 50 percent of his social security. For this retired investor, tax free is still tax free.

Sixth. S. 1113 should also be adopted because the current legislation discourages marriage among social security beneficiaries whose benefits, while currently untaxed, would be taxed if they were to marry.

For example, consider two social security beneficiaries who each receive $10,000 in pension benefits, $5,000 in tax-exempt income and $5,000 in social security benefits. As single people, the social security of each is not taxed. However, if they were married, they would exceed the $32,000 threshold and half their benefits would be taxed. If they decided to file separately, they would find that married people who do so are required to pay tax on half their social security benefits.

In summary, for the reasons discussed, American Jewish Congress supports the adoption of S. 1113, a bill to exclude tax-exempt interest in determining the income threshold for taxing social security benefits.

Senator D'AMATO. Let me thank you, Mr. Elkin, for coming in and making your presentation.

Let me say to both of you gentlemen that one of the things that I found quite discouraging is the fact that the Treasury Department in its analysis of my legislation has come up with a new revenue estimate where they say my bill would cost $234 million to the Federal Treasury. What they are saying is that people will switch into municipal bonds in greater numbers. They totally disregard the point that you made, that there will be great numbers of people who will not buy municipal bonds if there is precedent for their taxation. Then how will our cities raise money to help their citizens such as the elderly?

The person with the adjusted gross income of $120,000 or $200,000, they will certainly not give up municipal bonds as a technique to shelter income. The very people who we want to encourage to come in who are the backbone, so to speak, are the people who will be moving out and will be taxed unjustly.

I think we are creating a whole new class of tax cheats.

How will the Treasury determine who owns the municipal bonds since they are unregistered at the present time? I think we are creating a whole new class of tax cheats.

Mr. ELKIN. I could not agree with you more.

Senator D'AMATO. You have people that will say, "When I bought this bond, it was untaxable and now you are taxing me and it is unconstitutional," and they will simply exclude that municipal income.

Let me ask you this: Have either of you gentlemen noticed is there an awareness in the senior citizen community with respect to this provision and what are people saying, if anything?

Mr. GUILDROY. May I say that there is to this extent that our association, as you may know, conducts a program of tax aid to anyone, really, who asks for it, and a couple of days ago I checked with a couple of volunteers for the association who worked with this. I asked them what their feeling was, particularly about some of the statements that you made, Senator, on the floor of the Senate which appear in the Congressional Record.

They are completely with your position. They agree that people near the threshold will sell their tax-exempt bonds, perhaps partly to create a tax loss, but also so that they will get under the threshold and will not have to pay taxes on their social security. Both of them were quite adamant in their statements.

Senator D'AMATO. Have you noticed anything in terms of the seniors in your organization, Mr. Elkin? Are you becoming aware of this as a problem?

Mr. ELKIN. Our organization is not as large as Mr. Guildroy's. We are aware of the same phenomenon. We have a lot of people close to retirement and who will sell or not purchase any municipal bonds in order to remain below the threshold.

As we see it—to continue on with one of your remarks, it will cost the Government far more in administrative expense rather than raising revenue.

Senator D'AMATO. I wonder if there is any way that you can aid us in getting this message out to those within your organizations to inform them and ask for them to write to their Congressman or Congresswoman and others in the Senate. I think that might be——

Mr. ELKIN. We are doing that. We have brought that to the attention of our various regions around the country and the material that we have sent from the various organizations are sent through the various regions to consult with the proper party.

Senator D'AMATO. I know that your organization has put out a publication indicating the unfairness of taxing municipal bonds. That is a way to get passage of this bill.

Mr. ELKIN. You will receive our support.

Senator D'AMATO. Before getting to Mr. Municipal—I see Jim Lebenthal is here—and some of my colleagues in the Congress call him other things. We will take a 5-minute break.

[A brief recess was taken.]

Senator D'AMATO. The meeting will come to order and we will proceed with James Lebenthal, chairman of Lebenthal & Co.

Let me thank you for participating not only here today, but giving your strong support and all of your years of talent and research in this area. Hopefully, the testimony that you have given before the various committees of the Congress and the testimony you will give today will play a significant role to help educate the Congress on S. 1113. Many in Congress are totally unaware of this provision.

This provision which affects the income that comes from tax-free bonds was not part of the original report of the Social Security Commission. It was a last-minute addition. It came about as a result of some of those who demagoged the issue as one of fairness that somehow if you were getting income that was a tax-free setup, that income must be taxed.

Let me welcome you here again today.

STATEMENT OF JAMES LEBENTHAL, CHAIRMAN, LEBENTHAL & CO.

Mr. LEBENTHAL. "I'm Jim Lebenthal with the most un-understood investment in America."

Those are the opening words of a Lebenthal & Co., Inc., TV commercial about municipal bonds.

For 59 years now, Lebenthal & Co. has been specializing in tax-free municipal bonds catering almost exclusively to the individual investor. I am the son of the founder and chairman of the board. And having almost put the firm out of business at the beginning of the New York City crisis in 1975 with another advertisement—this one about New York City's general obligation bonds: "The Second Safest Investment

in America"—I learned my lesson. You do not use the superlatives most, best, biggest in securities advertising lightly.

Municipal bonds—the most "un-understood" investment in America? The public does not understand them. With all due respect, the press does not. I myself am perplexed half the time. But what finally convinces me of our rectitude in calling the bonds of our great American cities and States the most "un-understood" investment in America is the notion that prevails among many of our Federal lawmakers that tax exemption exists by the grace of Congress.

The exemption of State and local bonds from Federal taxation—and the exemption of Federal obligations from State and local taxation—springs from the 10th amendment, the reserved powers clause—of the U.S. Constitution.

Municipal bonds are tax free because—and these are all quotations—from decisions handed down by the U.S. Supreme Court:

> The power to tax involves the power to destroy.
>
> The great principle of self-preservation mandates the exception of states from undue interference by the Federal government.
>
> A tax on municipal bonds would operate on the power to borrow before it is exercised and (is) repugnant to the Constitution.
>
> A tax is a clog on the borrowing power.
>
> To tax the bonds as property in the hands of the holder is to impose a tax on the right of the municipality to issue them.
>
> The immunity of the states from Federal taxation is no less clear because it is implied.

Municipal bonds are free of Federal taxation—and vice versa—because the Constitution as interpreted by the Supreme Court established dual sovereigns. Under the reserved powers clause, neither the Federal Government nor the States may destroy each other. Neither the Federal Government nor the States may tax the instrumentalities of the other for carrying on their lawful affairs. Tax immunity is a two-way street. The States cannot tax Federal obligations. The Federal Government cannot tax the bonds of the States.

Because municipal bond interest is free of Federal income tax, the bonds of our cities and States pay less than taxable investments of comparable quality and maturity. True, investors may hope to gain more in Federal income tax savings than in interest foregone. But the principal beneficiary of low State and local bond interest rates are the issuing government and the local taxpayer. To pull the rug out from under the economic incentive people have for investing in and accepting between 25 and 30 percent less on their money at a time when municipal bonds are the only instrument we have for rebuilding America reminds me of Doctor Fagon in the Court of Louis XIV who bled babies to cure them of croup.

Bleed we must. We now have a law on the books that looks like a tax on municipal bonds, that feels like a tax on municipal bonds, but whose authors insist is not a tax on municipal bonds.

The Social Security Amendments of 1983 require recipients of social security benefits to pay tax on their benefits if gross income exceeds a threshold of $25,000 for single persons and $32,000 for marrieds. And tax-free municipal bond interest must be included in the threshold test.

Defenders of the provision say that requiring the inclusion of municipal bonds in the computation of the new social security tax is no different than requiring the inclusion of municipal bonds in the com-

putation of estate and inheritance taxes. After all we have State franchise taxes and Federal inheritance taxes that use the other's tax exempt securities as the measurement of the taxes due.

Yes, a tax may be measured by income even if part of such income is derived from immune sources, if there is a distinction of substance between what is being measured and what is being taxed.

A franchise tax is a tax on the exercise of the privilege of doing business. An inheritance tax is a tax on the activity of transferring property. But here the distinction is one of words, not substance.

Using tax-free municipal bond interest as a component of gross income to get at another component of gross income is tantamount to a tax on the bonds themselves. The object of the tax and the measurement of it are one and the same. One-half social security income plus taxable income plus tax-exempt municipal bond interest all go into the one pot and the part that boils over gets taxed. A tax on the excess is a tax on the base. But for the municipal bond interest there might be no tax.

You know it, I know it, and the mainstay of the municipal bond market, the individual investor will soon know it. "My social security benefits are being taxed because of my ownership of municipal bonds. What may be taxed next because of my municipals?" Who is to quantify the additional cost of borrowing to our cities and towns because of this uncertainty factor? Tax exemption is part of the rate the investor has bargained for. And if Congress can alter the tax status of the bonds, it is a signal to the bondholder that his or her bonds are not as safe, as immune from taxation as he or she thought. The investor will simply demand a higher rate to compensate for this new risk.

It is suggested that we municipal bond fellows should share the cost of saving the social security system, that we should grin and bear a small little ax in the name of fairness and equity. I would be squelched by the fairness issue if last year the Supreme Court had not confronted an almost identical situation except for the fact that Federal securities were involved.

In *American Bank & Trust Company* v. *Dallas County* the Supreme Court rejected, invalidated, threw out a State of Texas tax on bank shares because the tax failed to reduce the value of the shares by the portion of the bank's capital invested in Federal obligations.

Where is the fairness, where is the reciprocity, where is the dual sovereignty in the Federal Government—fresh from victory in the courts as to the immunity of its own obligations—now going out of its way to augment gross income for Federal tax purposes by the interest from State and local bonds?

I am for fairness.

I am for fairness to the Constitution. Fairness to the principle of reciprocity.

I am for fairness to the taxpayer singled out to pay tax on his or her municipal bonds—fairness to the old and retired.

I am for fairness to the bondholder who bought municipals never contemplating that his or her pension would be taxed because of the ownership of those bonds.

I am for fairness. Fairness to the local taxpayer who is going to bear the brunt of any additional cost of borrowing that results from the question, how may the bonds be taxed next?

The inclusion of municipal bond interest in the social security threshold test represents the most serious departure in intergovernmental relations I know—a judgment improvised with good intentions but with no real consideration for all its consequences. It came in the rush to save the social security system from financial collapse, but it came in the heat of night, in the "Quick, Henry, the Flit" mood that prevailed when the social security rescue bill was passed. It was not one of the Social Security Commission's original recommendations. It got passed without committee hearing. It just appeared one morning like a toadstool on the lawn.

In spite of great reluctance in the Congress to reopen the discussion of social security, Senator Alfonse D'Amato and Congressman Major Owens have introduced S. 1113 in the Senate and H.R. 3028 in the House to repeal the municipal bond inclusion provision. But, in truth, undoing one hair of the act to many of their colleagues comes under the heading of royal pain in the neck.

So I quote from Woodrow Wilson's Lecture on Constitutional Government in the United States, which we find in *Ozawa* v. *United States*, U.S. Supreme Court 1922:

> We are asked to conclude that Congress without the consideration or recommendation of any committee, without a suggestion as to the effect, or a word of debate as to the desirability of so fundamental a change—has radically modified a statute always theretofore maintained and considered as of great importance. It is inconceivable that a rule . . . a part of our history as well as our law, welded into the structure of our national policy by a century of legislative and administrative acts and judicial decisions, would have been deprived of its force in such a dubious and casual fashion.

Senator D'AMATO. Jim, thank you for your presentation. How have you disclosed this tax on municipal bonds? What do you say about it and what have you done?

Mr. LEBENTHAL. Has someone read the headline, "The Second Safest Investment in America" regarding the New York City bond when they were in difficulty? Naturally, I am one step ahead of the regulatory bodies. This is not a planned exchange between us, but I think the best way to answer the question is to simply produce our basic literature that we send out and advertise. It is this municipal bond information kit. I believe we must send out 50,000 of these a year. This is the January 1984 edition.

It would be to my advantage in the short run to keep this thing hush-hush for at least a year, because I do not think the public will feel the full impact until April of 1985 when they start paying tax.

We have a section in here, and I will read it: "The new company security tax, as we go to press, the last on the—" I will not read it. I go through the litany of, the short version of what I have presented to you.

We acknowledge that the tax exists. We say to the author of the provision that—and it goes on.

Legislation has been introduced to eliminate municipal bonds from any consideration of the new social security bond. We are for deleting the municipal bonds, and we believe that the Supreme Court will agree with that. That is the quiet way I acknowledge the stigma on the bond.

I know you are aware, Senator, because your counsel, Mr. Solomon, has kept you informed of our newsletters. I have to be very careful

in the running and writing of ads against myself because in this environment I am still trying to sell the bonds of our cities and States.

It is a very difficult razor's edge that I tread or whatever you do on a razor's edge. I have a conflict of interest. Right now I see it is to my interest to see the legislation passed because I cannot fathom the cost to this market that will be incurred in the 2, 3, or 4 years that it may take the Supreme Court to thrash out. I do not want to go to court with this.

Senator D'AMATO. That was my next question. I do not know if you heard Comptroller Goldin but he indicated that he was having his people look into it.

Mr. LEBENTHAL. I did.

Senator D'AMATO. In addition to the city's position, the position from the point of the inventors who are also being prejudiced that the suit carry more merit, you have not decided to preclude yourself from such a suit.

Do I take it that you would rather see a legislative formula? Would you consider joining in such a suit?

Mr. LEBENTHAL. Surely, I would if I have standing. I talk like a lawyer, but I am not a lawyer. As I understand it, you have to be adversely affected by this tax, and I do not mean your business drops off, but you have to be subject to the tax, liable for its payment and injured thereby.

Senator D'AMATO. By way of class action?

Mr. LEBENTHAL. I would love it.

Senator D'AMATO. And also there would be access to some of your customers and clients who would join in that class action suit?

Mr. LEBENTHAL. They would. They do and they say, "Why don't we?"

One reason we do not is because of the strong disinterest in getting into this can of worms. I guess like Anne Frank I believe in the essential goodness of mankind. I think that your colleagues will see the light and somehow that this bill will make some progress and there will be a solution to their problem.

Senator D'AMATO. There are some pretty powerful forces who are in opposition to my bill and any one Member of the Senate could bring it to a stop. I know of at least two or three that would do it.

I know as a former local officer, whenever I went to the bond market to sell bonds, to do highway maintenance or to build a highway garage, to purchase sanitation equipment, et cetera, that we were very, very concerned about the interest rates because a half percent increase in the rates, depending on the length and term of the bond, wound up costing the local taxpayers millions of dollars.

Thank you very much.

Mr. LEBENTHAL. Thank you for this opportunity, Senator.

Senator D'AMATO. The committee stands adjourned.

[Whereupon, at 12:30 p.m., the committee adjourned, subject to the call of the Chair.]

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